

Internal Revenue Service

memorandum

CC: LM: CTM: SJ

date: May 20, 2002

to: Examination Division - San Jose
Attn: [REDACTED] LMSB, International Examiner

from: Kendall Williams, Associate Area Counsel (LMSB:CTM:SJ)

subject: [REDACTED] EIN [REDACTED]
POSTF-11974-02

This is in response to your request for legal advice as to whether a tax deficiency is necessary in order to impose the information filing penalty under I.R.C. § 6038(b)(2). The question arises in regard to the examination of the taxpayer's FYE's [REDACTED] and [REDACTED] Federal corporate tax returns. It is our opinion based on our research and coordination with our National Office that a tax deficiency is not a prerequisite for imposing the penalty under section 6038(b). However, if the Service determines that the taxpayer's failure to comply with the reporting provisions was due to "reasonable cause", then the penalties may be waived by the Service.

FACTS

The salient facts are as follow:

- 1) The taxpayer, [REDACTED] Inc., located in [REDACTED], California, timely filed its Form 1120 Federal corporate tax returns for tax years ending April 30, [REDACTED], April 30, [REDACTED], and April 30, [REDACTED] respectively. These returns are currently under examination and due to foreign tax credit carry forwards there will be no deficiency due and owing for any of the taxable years. However, due to the taxpayer's failure to complete the required 5471 Forms, a \$[REDACTED] penalty under I.R.C. section 6038(b) (calculated at \$10,000 x [REDACTED] violations) is intended to be assessed.
- 2) The initial discovery of the incomplete Forms 5471 came about during the pre-audit analysis of the taxpayer's FYE [REDACTED] return. The Forms 5471 in question pertained to controlled foreign corporations (CFC's) located in [REDACTED], the [REDACTED] and [REDACTED]. In each case, the taxpayer did not complete Schedules A, B, C, E, F, H, J, and M. Rather, printed on almost every page of the Forms 5471 the taxpayer stated "[REDACTED]".
- 3) The examiner requested of the taxpayer completed Forms 5471 for the FYE

- return on [REDACTED] and [REDACTED].
- 4) On [REDACTED] the taxpayer provided the examiner with its' FYE [REDACTED] 1120 return which again had attached incomplete Forms 5471 for the three CFC's identified above, as well as a Form 5471 for a [REDACTED] CFC. Similarly the taxpayer on these Forms 5471 merely indicated "[REDACTED]". (The taxpayer's CEO has recently signed a declaration that the [REDACTED] entity was a branch, not a subsidiary).
 - 5) The taxpayer on [REDACTED] submitted Forms 5471 for the [REDACTED] [REDACTED], and [REDACTED] CFC's which indicated that the taxpayer owned [REDACTED]% of the voting stock of these three CFC's during the [REDACTED] tax years in question.
 - 6) A subsequent inspection of the taxpayer's FYE [REDACTED] return revealed that no Forms 5471 were filed for the [REDACTED] and [REDACTED] CFC's even though the beginning balances of the CFC's FYE [REDACTED] forms reflected that Forms 5471 should have been filed for these two CFC's in FYE [REDACTED] as well. (We understand that it has been determined not to impose the penalty for FYE [REDACTED]).

DISCUSSION

As you have stated, I.R.C. § 6038 (a) requires that each U.S. taxpayer submit for each controlled business entity specified background information such as name, principle place of business and country incorporated, and nature of business. In addition, the taxpayer is required to furnish a balance sheet for each such CFC, information detailing transactions engaged in between the taxpayer and such entity, as well as stock ownership information. Such information is to be furnished on a Form 5471 filed for each CFC with the taxpayer's 1120 return. (Treas. Reg. 1.6038-2(f)). I.R.C. § 6038(b) prescribes a penalty of \$10,000 for each annual accounting period with respect to which such failure to submit such information exists. An increased penalty is provided for in section 6038(b)(2) where such failure continues for more than 90 days after the Service notifies the taxpayer of its compliance failure. See Rev. Proc. 92-70, I.R.B. 1992-34 (August 5, 1992).

In the present case, the taxpayer did provide Forms 5471 for the named CFC's with the filing of its FYE [REDACTED] and [REDACTED] 1120 returns. However, as noted above, instead of furnishing the required information on the appropriate schedules of the Forms 5471, as prescribed by section 6038(a), the taxpayer cavalierly stated "[REDACTED]". As indicated in News Release IR-90-58 (INT), March 29, 1990, such a response is one of the most common examples of taxpayer noncompliance.

We informally discussed the issue of whether a tax deficiency is a prerequisite for assessing the penalty with attorneys in CC:INTL. We were advised that where the purpose of the form, such as Form 5471, is for furnishing information then no deficiency is needed.

Further, there is no language in either the code or regulations that states there is no imposition of the penalties without a tax deficiency. Moreover, pursuant to Treas. Reg. § 1.6038-2(k)(4) compliance with section 6038 is required even though there are no foreign tax credits which could be reduced by the penalties, and even though the information disclosed will not affect the taxpayer's liability to the Government under the code.

It should be also be noted that the prescribed penalty calculations are based on initial compliance and continued noncompliance, rather than as a percentage of any determined tax deficiency. In applicable language, in Wheaton v. United States, 888 F. Supp. 622 (D. N.J. 1995), the District Court opined that section 6038 additions are not subject to the deficiency notice rules even when they are "attributable to a deficiency", thus implying that in many instances, if not most, a tax deficiency is not involved. It is consequently our opinion that imposition of the section 6038(b) penalty is appropriate here notwithstanding there is no deficiency in either FYE [REDACTED] or [REDACTED] due to the carry forward of foreign tax credits.

The bigger question we believe is whether the information penalties should be waived in the present case upon a finding that the failures were due to reasonable cause and not to willful neglect. Treas. Reg. 1.6038-2(k)(3). In addition to averring that the penalties should be waived because there was no domestic tax impact, the taxpayer argues that the penalties should be waived because it disclosed the existence of the CFC's by filing and partially completing the Forms 5471 and that the intent of section 6038(b) is to penalize U.S. taxpayers who do not disclose the identity of its CFC's and its intercompany transactions with such CFC's.

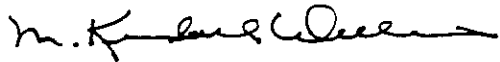
Initially it should be reiterated that whether the penalty should be waived is a determination that rests squarely within the province of the Service upon a finding of reasonable cause. Treas. Reg. 1.6038-2(k)(3). The only reference to what constitutes reasonable cause in the context of the information reporting penalties is in the Committee Reports on P.L. 101-239 (Omnibus Budget Reconciliation Act of 1989) wherein it is stated: "The committee intends that for this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements". In the present scenario although there exists present compliance/cooperation, in our opinion, this does not constitute reasonable cause for past failures. Moreover, no where is it stated in the Committee Reports that partial compliance, such as argued by the taxpayer for its CFC identification, is sufficient reasonable cause to waive the penalty. Although commentators to the final section 6038 regulations requested that a "minor noncompliance" exception be added to the penalty provisions, this was rejected for fear that such a standard might encourage taxpayers to submit incomplete information reporting forms. Treasury Decision 8850, I.R.B. 2000-2, 265, (Dec. 27, 1999). Consequently, only where a taxpayer can demonstrate "reasonable cause", will a waiver of the penalties be appropriate.

CONCLUSION

We find that as I.R.C. § 6038(b) is an information filing penalty, rather than an addition to tax, the fact there is no tax impact here is of no consequence. Only a finding by the Service of reasonable cause for the taxpayer's compliance will justify a waiver of the section 6038 (b) penalties. There has been nothing produced to date by the taxpayer that calls into question the inappropriateness of the Service's finding of no reasonable cause in the present case.

If you have any questions please either call Kendall Williams at 817-4666 or Caroline T. Chen at 817-4686.

Thank You,

A handwritten signature in black ink, appearing to read "M. Kendall Williams", written over a horizontal line.

M. KENDALL WILLIAMS
Associate Area Counsel

cc: Office of Chief Counsel
Technical Services Section
Room 4510